No. 83-832

IN THE

Supreme Court of the United States

October Term, 1983

HAROLD T. and MARIE B. PAULSEN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

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Question Presented for Review.

Whether a shareholder's exchange of shares in a stock-type savings and loan association for ownership savings accounts in a Federal mutual savings and loan association as part of a merger of the two institutions was a tax-free exchange in pursuance of a plan of reorganization within the meaning of Sections 368(a)(1)(A) and 354(a)(1) of the Internal Revenue Code.

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Harold T. and Marie B. Paulsen, Petitioners herein, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

Opinions Below.

The opinion of the Ninth Circuit is not yet reported and is set forth in its entirety in the Appendix hereto at 20-32. The opinion of the Tax Court, reversed by the Ninth Circuit, is reported as *Paulsen v. Commissioner*, 78 T.C. 291, Tax Ct. Rep. (CCH) Dec. 38,825, at 2807 (1982). It is set forth in the Appendix at 1-18.

Grounds for Jurisdiction.

The decision below was issued by the Ninth Circuit on August 16, 1983 and judgment was entered on that date. Petitioners did not file a petition for rehearing in the Ninth

Circuit. In accordance with 28 U.S.C. § 2101(c), this petition was filed within ninety days of the date judgment was entered. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Statutes Involved.

The relevant portions of Sections 354, 368 and 7701 of the Internal Revenue Code of 1954, as amended, 26 U.S.C. (the "Code"), and of 12 C.F.R. § 544.1(b), as in effect on July 1, 1976, are set forth in the Appendix at 34-35.

Statement of the Case.

On July 1, 1976, Commerce Savings and Loan Association of Tacoma ("Commerce"), merged into Citizens Federal Savings and Loan Association ("Citizens Federal"). Prior to the merger, Commerce was a state-chartered stock-type savings and loan association. It was owned by the shareholders of its guaranty stock. Citizens Federal is a federally chartered mutual savings and loan association. It is owned solely by its account holders whose accounts represent shares in the association.

Pursuant to a Plan for Merger, the petitioners, Harold and Marie Paulsen, exchanged their Commerce guaranty stock for Citizens Federal savings accounts which had a value in excess of their basis in the Commerce stock. On audit of the petitioners' 1976 Federal income tax return, the Commissioner asserted a deficiency based on his determination that petitioners were required to recognize gain in 1976 in an amount measured by the difference between the petitioners' adjusted basis in the Commerce guaranty stock they gave up and the face value of the Citizens Federal accounts they received in the merger.

The Commissioner issued a statutory notice of deficiency, and the Paulsens petitioned the United States Tax Court for

redetermination of the asserted deficiency. They contended that the merger was a reorganization of the two savings and loan associations within the meaning of Section 368 of the Code and that recognition of any gain on the exchange was therefore deferred by Section 354(a)(1) until such time as the petitioners withdrew or otherwise disposed of the Citizens Federal accounts they received in the transaction.

Section 354(a)(1) of the Code, on which the petitioners relied, provides that no gain or loss is recognized on an exchange of stock in a corporation that is a party to a reorganization for stock in the same or another corporation also a party to the reorganization if the exchange is in pursuance of the plan of reorganization. "Stock" in a "corporation" is defined by Section 7701 to include "shares in an association," and Section 368(a)(1)(A) of the Code includes "a statutory merger or consolidation" within the class of corporate transactions constituting a reorganization. I.R.C. § 7701(a)(3), (7) & (8).

The Tax Court, in an opinion by Judge Featherston, agreed with the petitioners' analysis of their transaction. It held that the exchange of guaranty stock for savings accounts pursuant to the terms of the merger did not trigger recognition of any gain under the Code. The Tax Court concluded that the accounts received by the petitioners and the other guaranty stockholders of Commerce provided them with the continuity of proprietary interest in the modified enterprise that is required under the case law and therefore constituted "stock" for purposes of the reorganization provisions of the Code. The court accordingly found that the merger was a "reorganization" exempt from taxation under Section 368(a)(1)(A) of the Code and that the petitioners had not recognized any gain because Section 354(a)(1) applied to their exchange. A decision was entered in the petitioners' favor on March 8, 1982. *Paulsen v. Commissioner*, 78 T.C.

291, 302-03, Tax Ct. Rep. (CCH) Dec. 38,825, at 2807 (Mar. 8, 1982).

The Commissioner appealed the Tax Court decision to the Court of Appeals for the Ninth Circuit. In an opinion written by Judge Norris with Judges Hug and Poole concurring, the Ninth Circuit reversed the Tax Court. *Paulsen v. Commissioner*, Slip Op. (August 10, 1983), set forth in the Appendix hereto at 20-32. The Court of Appeals concluded that a merger of a stock-type savings and loan association into a mutual savings and loan association does not constitute a reorganization exempt from recognition of gain or loss under the Code.

The parties filed a joint stipulation of facts in the Tax Court. Thus, as the Ninth Circuit found, "[t]he material facts are not in dispute." Slip Op. at 2. Both the Tax Court and the Court of Appeals agreed that the pertinent facts, which relate to the corporate structure of Commerce and Citizens Federal and to the consequences of the merger between the two entities, are as follows.

Commerce was a stock-type savings and loan association chartered by the State of Washington. Pursuant to its state charter, Commerce was authorized to issue guaranty stock, to offer various classes of non-ownership savings accounts, and to make loans. Each holder of a savings account or guaranty stock and each borrower was denominated a "member" of Commerce. With regard to matters requiring the approval of Commerce's members, holders of guaranty stock were entitled to one vote per share, holders of savings accounts to one vote per $100 on deposit, and borrowers to one vote each. The guaranty stockholders owned all the equity interest in Commerce. Holders of Commerce savings accounts held no interest in and had no liquidation rights in the net assets of the association.

Citizens Federal is a federally chartered mutual savings and loan association and, as a mutual institution, does not issue standard capital stock. Its charter, Charter K (Rev.), only permits it "[t]o raise its capital . . . *by accepting payments on savings accounts representing share interests in the association*." Charter K (Rev.) ¶ 3(6); 12 C.F.R. § 544.1(b) (as in effect on July 1, 1976) (emphasis added). Citizens Federal's account holders therefore hold all the proprietary rights and interest in the association and are the sole owners of its assets.

On matters which require approval from the members of the association, each holder of a savings account is entitled to one vote for every $100 (or fraction thereof) of the amount invested in his account, up to a maximum of 400 votes. A borrower from Citizens Federal is regarded as a non-proprietary member and is accorded one vote. Except for this one vote accorded each borrower, the account holders have the full voting power, and thus the ultimate control over the association. The account holders elect the Board of Directors, receive full annual financial reports on the association, can amend its charter and bylaws, and have the right to approve major changes of policy and organization. Only members of the association are eligible to become or remain directors.

Citizens Federal's charter and bylaws provide that twice each year its net earnings and any surplus are to be distributed to account holders on a pro rata basis. Account holders receive dividends which are expressly dependent upon the financial success of the association. Charter K (Rev.) ¶ 10. Distributions on accounts are made only out of profits of the enterprise, ratably according to the size of the investment. The amount of the distribution, if any, is determined and declared periodically by the Board of Directors. Charter K (Rev.) ¶ 10. If the association is not profitable or its

reserves in surplus are too low, no distribution will be made on any account, and the association is liable for none. Charter K (Rev.) ¶ 10.

In the event of the liquidation or dissolution of Citizens Federal, savings account holders are entitled to a pro rata distribution of its assets. Under the terms of its charter, Citizens Federal will also honor requests to withdraw by its savings account holders within thirty days, so long as funds are available to honor the redemption requests without jeopardizing the financial well-being of the institution.

On July 1, 1976, Commerce was merged into Citizens Federal. Under the Plan for Merger, shareholders of Commerce were to exhange their guaranty shares for savings accounts representing share interests in Citizens Federal. Each guaranty share of Commerce was exchanged for a $12 account in Citizens Federal, subject to the restriction that no account received in the exchange could be withdrawn for at least one year. Participants in the exchange were also given the right, in the merger agreement, to borrow money from Citizens Federal against the security of their accounts at a slightly lower interest rate (0.5% less) than that normally charged account holders for similar loans.

Petitioner Harold Paulsen was a director and the president of Commerce. Before the merger, Harold Paulsen and his wife owned 17,459 shares of Commerce guaranty stock with a cost basis of $56,802. Pursuant to the terms of the Plan for Merger, the Paulsens exchanged their guaranty stock for passbook and term savings accounts with a total face value of $209,508.

On appeal, the Ninth Circuit accepted the Government's argument that "the predominant characteristics" of the accounts received by the petitioners in the exchange "are those of debt rather than those of equity, and that, in reality, the

shareholders simply sold their guaranty shares for the equivalent of cash." Slip Op. at 1-2. The Court of Appeals concluded that the petitioners had received a debt interest in the merged corporation even though the Commissioner conceded that the accounts issued to the petitioners conferred "the right to vote, the right to share in the profits of the association, and the right to share in liquidation proceeds." Brief for the Appellant on Appeal from the Decision of the United States Tax Court in *Paulsen v. Commissioner*, at 8. The Ninth Circuit opinion also recognized that the "only owners" of Citizens are its account holders, but the court concluded that the "owners" were nothing more than "creditors" (Slip Op. at 12, 14), and decided that the merger should be treated as a sale rather than a reorganization within the meaning of the code.

The petitioners now seek review of the Ninth Circuit's decision and judgment on the application of the reorganization provisions of the Code to the merger of Commerce and Citizens Federal and to them as participants in that merger.

REASONS FOR GRANTING THE PETITION FOR A WRIT OF CERTIORARI.

This Court should grant a petition for certiorari. The decision of the Ninth Circuit directly conflicts with three other decisions on the same issue rendered by three different courts of appeals. The reasoning of the Ninth Circuit is also in conflict with the standards governing tax-free reorganizations established in a series of decisions by this Court. Finally, the proper interpretation of these sections represents an important issue of federal law which must be resolved.

I.

The Decision Below Is in Direct Conflict With Decisions Rendered by the Sixth Circuit, the Tenth Circuit, and the Court of Claims on the Same Issue.

In reversing the Tax Court's holding that the merger between Commerce and Citizens Federal was a tax-free reorganization, the Ninth Circuit stated that, "*[w]e recognize that our decision conflicts with that reached by several other courts.*" Slip Op. at 15 (emphasis added). The Ninth Circuit acknowledged that the Courts of Appeals for the Sixth Circuit and the Tenth Circuit and the Court of Claims have all held that mergers "similar to that here" of a stock savings and loan association into a mutual savings and loan association are tax-free reorganizations because the savings accounts in a mutual association are "stock" within the meaning of the Code. Slip Op. at 15. *See Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971). The Ninth Circuit nevertheless found that, "[w]e are neither bound nor persuaded by those authorities." Slip Op. at 16.

The direct conflict between the result reached by the Ninth Circuit in this case and the previous decisions of the Court of Claims and Courts of Appeals for the Sixth and Tenth Circuits was also acknowledged by the Tax Court and the Commissioner. The Tax Court declined independently to reexamine the question presented in this case, noting that the issue was not one of "first impression." 78 T.C. at 302-03. It concluded that the decisions in *Capital Savings*, *West Side Federal Savings*, and *Everett* should not be reevaluated because they represented a "long outstanding and unbroken line of holdings . . . that savings accounts in a mutual savings and loan association qualify as 'stock'. . . ." 78 T.C. at 303.

Similarly, the Commissioner did not even attempt to persuade the Ninth Circuit that the above three decisions were consistent with the interpretation of the Code he advanced. Instead, he took the position that those opinions "were wrongly decided" and argued, "[t]hat other courts may have reached erroneous non-tenable conclusions . . . should in no way constrain [the Ninth Circuit] to do the same." Brief for the Appellant on Appeal from the Decision of the United States Tax Court in *Paulsen v. Commissioner, supra*, at 23, 26. A review of the opinions issued by those courts readily reveals why the Commissioner, the Tax Court and the Ninth Circuit made no effort whatsoever to distinguish the facts or legal issues they presented from those presented in this case.

In *Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979), the court held that the statutory merger of Franklin, a state guaranty stock-type association into Capital, a mutual association whose capital consisted solely of voting ownership accounts, qualified as a reorganization under Section 368(a)(1)(A) of the Code. *Id.* at 971-72. The Government had contended that the receipt by

Franklin guaranty stockholders of the Capital savings accounts should be characterized as a sale rather than as a "reorganization" on the basis of the same theory asserted by the Commissioner in the Ninth Circuit: the mutual savings and loan association accounts received by the former guaranty stockholders were predominantly debt rather than "stock" and therefore did not transfer a sufficient proprietary interest to the account holders to warrant characterization of the transaction as a reorganization rather than a sale. *Id.* at 974; Brief for the United States in Support of its Motion for Summary Judgment in *Capital Savings & Loan Association v. United States*, Ct. Cl. No. 552-76 (Oct. 17, 1979), at 11.

The Court of Claims rejected the Government's theory that the accounts did not represent a continuation of a proprietary interest in the reorganized entity:

> As the law assumes that someone must own an association or corporation, we joint the courts in *West Side, supra*, and *Everett, supra*, in refusing to reach a decision which illogically implies that . . . [a mutual savings and loan association] is without owners and which may unduly hinder otherwise desirable reorganizations. Though savings accounts are easily converted into cash, as long as the account remains unliquidated, its holders continue their equity investment in the association in the form of share accounts.

607 F.2d at 976 (footnote omitted).

Both the *Capital* decision and the Tax Court's decision below were solidly grounded in precedent. Eight years before *Capital*, shortly after the Commissioner began his efforts to refuse tax-free reorganization status to transactions in which mutual savings and loan associations used their accounts to acquire guaranty stock associations, the Court of Appeals for the Tenth Circuit had held that such accounts

constituted "voting stock" of an acquiring federal mutual savings and loan association within the meaning of Section 368(a)(1)(C) and (2)(B) of the Code. *Everett v. United States*, 448 F.2d 357, 359-60 (10th Cir. 1971). In so holding, the Tenth Circuit rejected the argument advanced by the Commissioner that "such interest more nearly represents that of a creditor than a true proprietary interest and hence cannot be said to constitute 'solely voting stock'." *Id.* at 359.

Following *Everett*, in a case which the Tax Court characterized as "identical" to this case "in all material respects," the Court of Appeals for the Sixth Circuit held that the merger of a state stock-type savings and loan association into a federal mutual association qualified as a tax-free reorganization within the meaning of Section 368(a)(1)(A). *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404, 405, 411 (6th Cir. 1974). There again, the Commissioner had asserted that a federal mutual account holder's equity interest "was minimal compared to his rights as a creditor" and argued that the conversion of the state association's stock into voting membership accounts in the federal mutual association pursuant to the merger was in essence an exchange of stock for "cash or its equivalent." *Id.* at 406, 409, 411. Once again, the contention was rejected. *Id.* at 411.

Relying on the applicable decisions of this Court, the Sixth Circuit found that "there is no requirement that the relationship of the transferor or its shareholders to the assets transferred remain unchanged. The interest which the transferor or its shareholders acquire must be at least in substantial part a proprietary or equity interest," but the holdings of the Supreme Court do not direct the courts to "conduct an examination to determine whether the shareholder of the merged corporation receives more or less of a proprietary interest than he surrendered." 494 F.2d at 409, 411. For

this reason "it is improper to ignore the proprietary rights" conferred by share accounts in a mutual association simply because the proprietary rights in a stock association may have been greater. The court accordingly held that the exchange of guaranty stock for membership accounts constituted a "reorganization" under the Code. In stark contrast, the Ninth Circuit has held in this case that the exchange of the identical ownership interests did *not* constitute a "reorganization," reasoning that "[t]he critical question . . . is whether the position of the shareholders in the reorganized entity has really changed," and concluding that the exchange in question "converted a risky investment into a risk-free one and a highly illiquid position into a highly liquid one." Slip Op. at 14.

The interpretive conflict created by the Ninth Circuit opinion in this case should be resolved by this Court. First, the conflict between the Ninth Circuit opinion and that of the other appellate decisions and the Court of Claims is direct: the Court of Claims, the Sixth Circuit and the Tenth Circuit have held that accounts in a federal mutual savings and loan association *are* "*stock*" and that, accordingly, a merger of a stock-type savings and loan association into a mutual savings and loan association *is a tax-free reorganization* within the meaning of the Code; conversely, the Ninth Circuit held that such accounts are *not* "*stock*," so that the merger of a stock-type savings and loan association into a mutual savings and loan association *is not a tax-free reorganization* under the Code.[1]

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[1]The only difference between these cases is that the taxpayer in the three prior cases was the corporation, rather than the shareholder. The same statutory provisions are in issue, however. As the Government has repeatedly acknowledged, the characterization of a merger such as this as a reorganization does not depend upon who is the taxpayer. If the transaction qualifies as a reorganization for the associations involved, it necessarily follows that it is a tax-free reorganization exchange for the former guaranty stockholders of the acquired association. The Government in fact has acknowledged that it would be "plain nonsense" to reach any other result. Reply Brief for the United States in Support of its Motion for Summary Judgment in *Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979), at 10 n. 4. For this reason, the Ninth Circuit and the Commissioner do not rely upon this difference in the identity of the taxpayer. It is immaterial to the issue of statutory interpretation presented.

Second, it cannot be expected that uniformity will be restored to this area of the law without resolution of the issue by this Court. The three decisions in conflict with the Ninth Circuit opinion are recent and thoroughly reasoned. Further, the Ninth Circuit did not rely upon any statutory or judicial developments subsequent to the issuance of the prior decisions which would be likely to change the outcome reached by those courts. Thus, the conflict can be expected to persist even after other lower federal courts have an opportunity to consider the opinion of the Ninth Circuit.

Third, this case presents an excellent opportunity for the resolution of the conflict. There are no factual disputes. There are no material factual differences between the merger in issue and the typical merger of a stock-type savings and loan association into a mutual savings and loan association. There are no other issues involved which could support the judgment of the Ninth Circuit. Thus, nothing would prevent this Court from reaching and resolving the conflict.

Finally, as set forth more fully below, the issue raised is a recurring one. This is therefore not a conflict which this Court should decline to resolve on the ground that the issue is unlikely to reappear in the future. The lower federal courts have addressed the issue on a number of occasions, they have now reached conflicting opinions, and uniformity will not be restored until this Court resolves the dispute.

II.

The Decision Below Is Contrary to Decisions of This Court.

The decision of the Ninth Circuit is in conflict with this Court's interpretation of the Code provisions governing tax-free reorganizations and the nature of an account holders' legal interest in a mutual savings and loan association.

First, the Ninth Circuit held that a business transaction unquestionably encompassed by the literal language of the Code nevertheless failed to qualify as a "reorganization" even though this Court has directed that Congress intended an expansive interpretation of these sections.

Section 368 of the Code, which sets forth the types of corporate transactions that constitute a "reorganization," includes within the meaning of that term "a statutory merger or consolidation." I.R.C. § 368(a)(1)(A). In conjunction with Section 368, Section 354 provides that

> [n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

I.R.C. § 354. Congress defined the term "corporation" in the Code to include an association, the term "stock" to include "shares in an association" and the term "shareholder" to include a "member in an association." I.R.C. §§ 7701(a)(3), (7) & (8).

By their express terms, these Code sections apply to the transaction at issue in this case. The taxpayers exchanged stock for "shares in an association" in "pursuance of the plan of reorganization." A literal reading of Section 354 would therefore exempt the petitioners' exchange, but the Ninth Circuit declined to allow the words chosen by Congress to govern.

The Ninth Circuit's reluctance to implement the terms used by Congress is inconsistent with this Court's direction in *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933). In *Pinellas*, the Court had its first opportunity to construe which transactions Congress intended to exempt from taxation under the predecessor to Section 368 of the Code. Although it found that the transaction at issue there was a sale of assets for short term notes and therefore not a reorganization, the Court expressly rejected the lower court's restrictive interpretation of the language included in the statutory provisions, noting that Congress intended to "expand the meaning of 'merger' or 'consolidation' " to confer tax exempt status even to some transactions "beyond the ordinary and commonly accepted meaning" of the terms. *Id.* at 470. That reading of legislative intent with respect to the reorganization statutes was reaffirmed in 1954 when Congress enacted Sections 368 and 354 of the Code. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954) (expressing concern that different types of corporations not be singled out for more restrictive application of the reorganization sections and rejecting portions of a House bill that attempted a "precise" definition of the term "stock"). In deciding that "shares in an association" of savings and loan account holders are more readily viewed as "debt" rather than "stock," the Ninth Circuit denied effect to this Court's conclusion that Congress sought to expand the "commonly accepted meaning" of the terms employed.

Second, the Ninth Circuit held that a transaction which effected a bona-fide restructuring of the business ownership and operations of two savings and loan institutions, after which the same persons remained the owners of the combined entity, did not represent a "reorganization." This

Court, however, has only withheld "reorganization" treatment from those transactions structured as reorganizations in situations where (i) the transferor shareholders do not remain owners of the resulting enterprise or (ii) which have been designated by the taxpayers as "reorganizations" for the sole purpose of tax evasion. That is, the Court has concluded that although Congress intended an expansive interpretation of "reorganization," it did not intend to defer recognition of gain simply because the taxpayer has labeled what is *in fact* nothing other than a "sale" or other profit "distribution" a statutory "reorganization." *See Pinellas v. Commissioner, supra*, 287 U.S. at 468, 470 (acquisition of assets in exchange for cash and short-term notes was a sale and not a reorganization because seller did not "acquire an interest in the affairs of the purchasing company"); *Le Tulle v. Scofield*, 308 U.S. 415, 420-21 (1940) (similarly, for transfer of assets in exchange for cash and bonds); *Bazley v. Commissioner*, 331 U.S. 737, 742-43 (1947) (no reorganization where "nothing was accomplished that would not have been accomplished by an outright debenture dividend").

The instant case does not come within the limited exceptions to reorganization treatment announced by this Court for transactions that literally comply with the statute. Where, as here, the transferor shareholders have continued as owners of the new entity after a merger, the Court has only refused to give effect to the literal meaning of the Congressional language if the transaction was arranged and designated as a "reorganization" by the taxpayer for no "corporate purpose" other than tax avoidance. *See, e.g., Gregory v. Helvering*, 293 U.S. 465, 467, 470 (1935) (holding that the transfer of shares to a shell corporation which never conducted any business and was dissolved in less than a week for the sole purpose of "diminish[ing] the amount of

income tax" was "an operation having no business or corporate purpose" and therefore not a "reorganization" under the statute). It was never alleged in this case that the transaction at issue did not serve all the corporate purposes of a reorganization. The merger was a "bona fide business move" which the "details of corporate affairs" reveal accomplished far more than tax deferral. Under this Court's decisions, such a transaction qualifies as a reorganization exempt from taxation. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935).

Third, the Ninth Circuit determined that the "critical question" in implementing the statutory scheme is "whether the position of the shareholder in the reorganized entity has really changed" (Slip Op. at 14), even though this Court has repeatedly emphasized that the question is not whether "the relationship of the taxpayer to the assets conveyed was substantially changed," but instead whether the taxpayers received an "interest in the transferee" which is "definite and material." *Helvering v. Minnesota Tea*, 296 U.S. at 385-86 (holding that a reorganization occurred despite a substantial change of position in the interest held by the transferor stockholders); *see John A. Nelson Co. v. Helvering*, 296 U.S. 374, 377 (1935) (holding that the receipt by shareholders of the transferor corporation of non-voting callable preferred stock in exchange for their common stock in the acquired corporation gave them a "definite and substantial interest in the affairs of the [acquiring] corporation"). In essence, the Ninth Circuit concluded that because the risk and liquidity of the petitioners' position changed, no reorganization exchange occurred. Slip Op. at 14. Yet this Court has stated that such change is not "inhibited by the statute." 296 U.S. at 386.

The Commissioner's published rulings demonstrate that it is his position, the position now endorsed by the Ninth

Circuit, that the *nature* of the interest received by the petitioners is not controlling, but that it is the *degree of change* in the proprietary interest received that is controlling. For instance, the Commissioner has ruled publicly that accounts in mutual savings and loan associations constitute "stock" if exchanged for other savings accounts (regardless of whether these are proprietary in nature) or for the stock of a guaranty stock-type association; yet these same accounts are *not* "stock" if received in exchange for guaranty stock. *Compare* Rev. Rul. 69-3, 1969-1 C.B. 103 (merger of two mutual savings and loan associations constitutes an "A" reorganization) and Rev. Rul. 69-646, 1969-2 C.B. 54 (merger of a mutual savings and loan association into a guaranty stock-type savings and loan association is a tax-free reorganization) *with* Rev. Rul. 69-6, 1969-1 C.B. 104 (merger of a guaranty stock-type association into a mutual association constitutes a "sale of assets" and not a reorganization within the meaning of Section 368(a)(1)(A)). There can be no doubt, therefore, that the Commissioner seeks to tax a change in the nature of a proprietary interest as precluded by the decisions of this Court.

Finally, the Ninth Circuit held that a share in a mutual savings and loan association is "the equivalent of cash," rather than "stock," even though this Court has held that such shares are "stock" in other statutory schemes. *Tcherepnin v. Knight*, 389 U.S. 332 (1967). The court below characterized the shares received as "debt" and not "stock" despite its conclusion that the account holders were the only "owners" in the reorganized corporation, that the accounts "may be ownership interests for some purposes," and that the "passbook accounts are equity in the sense that they represent the entire capital structure of the association" because, it stated, the shares "are in reality indistinguishable from ordinary cash savings accounts and are essentially the

equivalent of cash." Slip Op. at 12-14.

The Ninth Circuit's construction of the term "stock" is directly at odds with this Court's classification of account holders' interest in a mutual savings and loan association. In *Tcherepnin*, this Court concluded that the equity characteristics and investment risks present in the same type of accounts at issue in this case were sufficient to characterize them as "stock" within the meaning of the Securities and Exchange Act. This Court held:

> *Petitioners are participants in a common enterprise — a money-lending operation dependent for its success upon the skill and efforts of the management of City Savings in making sound loans. Because Illinois law ties the payment of dividends on withdrawable capital shares to an apportionment of profits, the petitioners can expect a return on their investment only if City Savings shows a profit. If City Savings fails to show a profit due to the lack of skill or honesty of its managers, the petitioners will receive no dividends. Similarly, the amount of dividends the petitioners can expect is tied directly to the amount of profits City Savings makes from year to year.* Clearly, then, the petitioners' withdrawable capital shares have the essential attributes of investment contracts as that term is used in § 3(a)(10) and as defined in *Howey*. But we need not rest our decision on that conclusion alone . . . . *For example, the petitioners' shares can be viewed as "certificate[s] of interest or participation in any profit-sharing agreement." The shares must be evidenced by a certificate, and Illinois law makes the payment of dividends contingent upon an apportionment of profits. These same factors make the shares "stock" under § 3(a)(10).*

389 U.S. at 338-39 (footnotes omitted and emphasis added).

The same characterization of the interest in issue was rendered by the Court of Appeals for the District of Colum-

bia Circuit in an opinion written by then Circuit Judge Burger. *Wisconsin Bankers Association v. Robertson*, 294 F.2d 714 (D.C. Cir.), *cert. denied*, 368 U.S. 938 (1961). The court there rejected a challenge that new regulations issued by the Federal Home Loan Bank Board unlawfully permitted federal savings and loan associations to accept deposits, and thus act as banks. In his concurring opinion upholding the new regulations, then Circuit Judge Burger, while noting that there are many "superficial similarities" between mutual savings and loan associations and banks, stressed certain material differences between accounts in a federal savings and loan association and deposits in a bank:

> [W]e are *concerned not with appearances but with legal realities*; it is here that the differences are marked as Judge Miller has pointed out. *The capital of a federal savings association is raised by payments on share interests. Calling them "payments" on "savings accounts" does not alter their legal status. That the payment may be regarded by the customer as a "deposit" or even called at times a deposit by the association does not make it a legal counterpart of a deposit in a bank. The "depositor" in a federal association is not a creditor* as is the depositor in a bank . . . . *He is an investor, as the very language of Section 5(b) of the Home Owners Loan Act describes the relationship*. The owner of a "savings account" in the association is entitled to vote, in much the same way as a stockholder in a corporation, to elect the management. The Act under which they exist recites the congressional purpose which emphasizes the "investment" character of these shares and distinguishes them from the creditor-debtor relationship between a bank account depositor and a bank.

294 F.2d at 717-18 (citations omitted and emphasis added).[2]

For the reasons set forth, the opinion of the Ninth Circuit is inconsistent with this Court's interpretation of the same statutory framework.

III.
The Court Below Decided an Important Question of Federal Law Which Needs to Be Settled by This Court.

The importance of a uniform and predictable interpretation of the Code sections governing corporate reorganizations has repeatedly been recognized by this Court, lower federal courts and by the Internal Revenue Service. This Court has thus granted petitions for certiorari raising issues concerning the interpretation of those provisions on at least six occasions. As the Court explained in *Bazley*, "[t]he proper construction of the provisions of the Internal Revenue Code relating to corporate reorganizations" has sufficient "importance to the Treasury as well as to corporate enterprise" to warrant certiorari. *Bazley v. Commissioner*, *supra*, 331 U.S. at 738. Similarly, in its earlier opinion in *Gregory v. Helvering*, the Court specifically noted that the Government had not opposed the taxpayers' petition for certiorari on an issue of "reorganization" interpretation, "considering the question one of importance." 293 U.S. at 468.

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[2]The Commissioner himself consistently took the same position as the courts for many years. *See* Rev. Rul. 54-624, 1954-2 C.B. 16, 17-18 stating:

> [T]he rights possessed by the shareholders of [a federal mutual savings and loan] association are in the nature of proprietary interests which are not at all similar to the rights of a general or special depositor in a bank.

Accord, Rev. Rul. 58-34, 1958-1 C.B. 333, 334 (no debtor-creditor relationship exists between a federal savings and loan association and holders of savings accounts in such association); I.T. 4045, 1951-1 C.B. 34 (account holders are proprietors rather than creditors of the association).

The Tax Court in this case acknowledged the necessity for uniformity in the law on the issue before it when it declined the Commissioner's invitation to reevaluate the soundness of the prior decisions of the Sixth and Tenth Circuits and the Court of Claims. The Tax Court emphasized that "the need for certainty in the law is great because of the high stakes and advanced planning associated with reorganization." 78 T.C. at 303.

The need for certainty and uniformity on the reorganization question presented for review in this case is particularly compelling because of the frequency of savings and loan association mergers. Officials of the Federal Savings and Loan Insurance Corporation advised counsel for the petitioners that 425 mergers of savings and loan associations took place last year. Many of those mergers involved mutual associations. In addition, examination of records available through the Federal Home Loan Bank Board revealed that there have been 11 acquisitions similar to this one in California alone since 1974. In each, the stock of a state association was exchanged for accounts in a mutual association.

The proper tax treatment of every savings and loan association merger and of each shareholder who exchanged guaranty stock for accounts in a surviving mutual association pursuant to such a merger has now been called into question. Litigation of the same issue presented here is therefore sure to follow in numerous cases in the Tax Court and other lower federal courts, as well as the Court of Claims. Indeed, according to an Affidavit filed with the Tax Court in June of 1981 by Edward M. Robbins, Jr., counsel for the respondent in *Owens v. Commissioner*, Docket Nos. 9412-79 and 11711-80, 36 cases arising out of one of the California transactions mentioned above, which took place in 1975, had already been filed at that time. Those cases are now pending before the Tax Court.

Further, as the Court of Claims recognized when it "refuse[d] to reach a decision which illogically implies that . . . [a mutual association] is without owners and which would unduly hinder otherwise desirable reorganizations" (697 F.2d at 976), the uncertainty created by the decision of the Ninth Circuit impacts upon future as well as past mergers. The tax consequences of an exchange of ownership shares must be considered in establishing the values of the interests to be exchanged pursuant to a plan of merger. The ruling of the Ninth Circuit makes such valuations speculative. It also disadvantages a federally chartered mutual savings and loan association competing with a state stock-type association for the acquisition of other associations by creating tax disincentives for mergers with a federal mutual association. The question presented by this case is therefore of great practical importance to corporate planners, to the savings and loan industry, to individual taxpayers and to administrators of the Internal Revenue laws.

Conclusion.

For all the foregoing reasons, the petition for a writ of certiorari should be granted.

Dated: November 14, 1983.

Respectfully submitted,

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APPENDIX.

Opinion of the United States Tax Court.

78 T. C. No. 21.

United States Tax Court.

Harold T. and Marie B. Paulsen, Petitioners *v.* Commissioner of Internal Revenue, Respondent.

Received: March 8, 1982.

Docket No. 17549-79. Filed March 2, 1982.

In 1976, petitioners exchanged "guaranty stock" in a State-chartered savings and loan association for savings accounts in a Federally-chartered mutual (nonstock) savings and loan association pursuant to a plan for the merger of the two associations. The savings accounts carry with them certain proprietary rights such as the right to vote, the right to pro rata distributions of earnings, and the right to share in the distribution of assets upon liquidation.

Held, the savings accounts constitute proprietary interests which satisfy the "continuity of interest" required in a reorganization under sec. 368(a)(1)(A), I.R.C. 1954, and, therefore, petitioners are entitled to treat the exchange of guaranty stock for savings accounts as a "tax-free" exchange under sec. 354(a)(1), I.R.C. 1954. *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. 557, 607 F.2d 970 (1979); *West Side Fed. S. & L. Ass'n of Fairview Pk. v. United States*, 494 F.2d 404 (6th Cir. 1974); and *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971), followed.

Duane Tewell and *David Tewell*, for the petitioners.

Wayne R. Appleman, for the respondent.

OPINION

FEATHERSTON, *Judge*: Respondent determined a deficiency in the amount of $40,913 in petitioners' Federal income tax for 1976. The only issue for decision is whether

the exchange of "guaranty stock" in a State-chartered savings and loan association for passbook accounts and time certificates of deposit in a Federally-chartered mutual savings and loan association qualifies as a tax-free exchange under section 354(a).[1]

This case was submitted fully stipulated.

At the time the petition was filed, petitioners Harold T. and Marie B. Paulsen, husband and wife at all times material herein, resided in Tacoma, Washington. They filed a joint Federal income tax return for 1976 with the Internal Revenue Service Center, Ogden, Utah.

During the 12-month period preceding June 30, 1976, petitioner Harold T. Paulsen was the president and a director of Commerce Savings and Loan Association of Tacoma (Commerce). Commerce, a State chartered savings and loan association, was incorporated and operated under the laws of the State of Washington.

Under its articles of incorporation and bylaws, Commerce was authorized to issue "guaranty stock" and several classes of savings accounts. Each holder of a savings account or guaranty stock, as well as each borrower, was a "member" of Commerce. With respect to all questions requiring action by the members, holders of savings accounts received one vote for each $100 in their accounts, and guaranty stockholders received one vote per share of stock. Each borrower from Commerce was also entitled to one vote. A majority of the board of directors of Commerce were required to be owners of guaranty stock.

A minimum amount of guaranty stock, specified by a formula, was required to be "maintained as fixed and permanent nonwithdrawable capital" of Commerce. Guaranty stockholders had a proportionate proprietary interest in the assets and net earnings of Commerce subordinate to the claims of its creditors; no other member had such an interest.[2] Guaranty stock was not eligible as a security for loans from Commerce, and it could not be "withdrawn" until the claims of all creditors and holders of savings accounts had been satisfied upon liquidation or dissolution. Dividends on guaranty stock could not be declared unless certain reserves had been accumulated, and they could not be paid or credited during any period in which dividends had not been declared and paid upon withdrawable savings. The rate of dividends on guaranty stock was to be fixed by the board of directors.

On June 30, 1976, petitioners owned 17,459 shares of guaranty stock in Commerce. Of these shares, 1,390 shares were acquired on that day pursuant to a qualified stock option plan of Commerce. All of petitioners' stock in Commerce was held as community property.

Citizens Federal Savings and Loan Association of Seattle (Citizens or the association) is a Federally-chartered mutual savings and loan association which was authorized, organized, and chartered by the Federal Home Loan Bank Board under the provisions of 12 U.S.C. sec. 1461, et seq., and

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[1]All section references are to the Internal Revenue Code of 1954, as in effect during the tax year in issue, unless otherwise noted.

[2]The bylaws submitted with the stipulation state that "each holder of a savings account or guaranty stock" shall have a proportionate proprietary interest in the assets or net earnings. However, they further state that any provision of the bylaws in conflict with State law "shall be deemed amended to conform therewith." During the years in question, Wash. Rev. Code Ann. sec. 33.48.080 (Supp. 1981), provided as follows:

> Each member having guaranty stock in an association shall have a proportionate proprietary interest in its assets and net earnings subordinate to the claims of its creditors * * *; but [subject to an exception not pertinent here] no other member * * * shall have any such interest * * *.

the regulations promulgated thereunder. Citizens has no capital stock. It is owned by its members who consist solely of savings account holders and borrowers. In the consideration of questions requiring action by its members, each holder of a savings account has one vote for each $100 (or fraction thereof) of the withdrawal value of his savings account, and each borrower has one vote.

The charter of Citizens states in part that the "objects of the association are to promote thrift by providing a convenient and safe method for people to save and invest money and to provide for the sound and economical financing of homes." Under the charter, Citizens has the power to raise capital only "by accepting payments on savings accounts representing share interests in the association." Generally speaking, requests for withdrawals from savings accounts must be honored within 30 days of the request. In this connection, Citizens' charter provides that: "Holders of savings accounts for which application for withdrawal has been made shall remain holders of savings accounts until paid and shall not become creditors." All savings accounts of Citizens are "nonassessable."

The Citizens charter further provides that as of June 30 and December 31 of each year, after provision has been made for payment of expenses, credits to general reserves and surplus, and bonuses on savings accounts as authorized by Federal Home Loan Bank Board regulations, any remaining net earnings are to be distributed in proportion to the withdrawal value of savings accounts. In lieu of or in addition to such net earnings, any surplus of the association may be similarly distributed. In the event of voluntary or involuntary liquidation, dissolution, or winding up of Citizens, all holders of savings accounts are "entitled to equal distribution of assets, pro rata to the value of their savings accounts." Citizens has the power to redeem all or any part

of its savings accounts at a price equivalent to "the full value thereof, as determined by the board of directors, but in no event shall the redemption price be less than the withdrawal amount" of any savings account.

On or about July 1, 1976, the guaranty stockholders of Commerce exchanged all of their stock for passbook accounts and time certificates of deposit in Citizens. This exchange was made in accordance with the provisions and intent of a "Plan for Merger" of Commerce and Citizens dated November 7, 1975.

Pursuant to the provisions of the plan for merger, each share of guaranty stock in Commerce was to be exchanged for a $12 deposit in a regular passbook savings account in Citizens, subject to the restriction that such deposits could not be withdrawn for a period of 1 year. Alternatively, Commerce shareholders had the option of exchanging their stock (at the same dollar rate per share) for time certificates of deposit in Citizens with maturities ranging from 1 to 10 years.[3] The plan for merger further provided that each prior shareholder of Commerce would have borrowing privileges against the deposits resulting from the exchange of stock at an interest rate 1.5 percent above the passbook rate.[4]

Upon completion of the exchange, Commerce was merged into Citizens and the combined business activity of the two was continued in the name of Citizens.[5] The exchange and

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[3]Although this option was within the intent of the parties to the merger, through a typographical error, the plan for merger does not reflect the terms of the option.

[4]Generally, Citizens savings account holders were charged interest at a rate 2 percent above the passbook rate on loans secured by their accounts. The passbook rate during the period July 1, 1976 through June 30, 1977, was 5.25 percent.

[5]Each Commerce savings account outstanding on the effective date of the merger was converted to a savings account of the same size in Citizens.

merger were treated by Citizens and Commerce as a reorganization under section 368(a)(1)(A) resulting in no recognized gain or loss to Commerce shareholders pursuant to section 354(a).

On July 1, 1976, in accordance with the above-described plan for merger, petitioners exchanged the following shares of guaranty stock in Commerce for passbook accounts and time certificates of deposit in Citizens:

Number of Shares	Date of Acquisition	Cost Basis	Consideration Received		Gain Realized
			Amount	Type	
3,356	3/ 8/63	$ 7,500	$ 40,272	Passbook	$ 32,772
3,359	6/26/70	7,500	40,308	2 yr. cert.	32,808
3,358	12/31/71	7,500	40,296	18 mos. cert.	32,796
3,358	10/24/72	7,500	40,296	18 mos. cert.	32,796
667	1/ 1/73	7,530	8,004	1 yr. cert.	474
1,971	2/19/74	6,000	23,652	3 yr. cert.	17,652
861	6/30/76	7,500	10,332	3 yr. cert.	2,832
529	6/30/76	5,772	6,348	4 yr. cert.	576
17,459		$56,802	$209,508		$152,706

Petitioners treated this exchange as one requiring the recognition of the gain realized only upon the withdrawal of monies from the passbook accounts or upon the maturity of the time certificates of deposit. Therefore, they reported no gain from the exchange on their Federal income tax return for 1976.[6]

Respondent determined in the notice of deficiency that petitioners were required to recognize in 1976 the gain realized from the exchange of the Commerce stock for Citizens passbook accounts and time certificates of deposit.

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[6]Petitioners had made no withdrawals from their passbook accounts between July 1, 1976, and the date that the stipulation was submitted. The record does not indicate whether petitioners had reported gain upon the maturity of any of the time certificates.

Under section 1001,[7] the entire amount of any gain realized on the sale or exchange of property must be recognized for income tax purposes unless it is otherwise provided in the Code. Section 354(a)[8] provides in part that no gain shall be recognized if pursuant to a plan of reorganization, stock or securities in a corporation that is a party to the reorganization are exchanged for stock or securities in another corporation that is a party to the reorganization.

As used in section 354(a), the term "reorganization" includes a merger or consolidation effected under applicable

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[7]SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. * * *

(c) Recognition of Gain or Loss.—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

* * *

[8]SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) General Rule.—

(1) In general.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) Limitation.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(3) Cross reference.—For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

State or Federal law. Sec. 368(a)(1)(A); sec. 1.368-2(b)(1), Income Tax Regs. It is undisputed that the merger of Commerce and Citizens was effected as authorized by law. However, treatment of the merger as a "reorganization" for tax purposes does not necessarily follow from the fact that it was formally conducted in accordance with applicable law. There is an additional requirement, judicially created and now set forth in section 1.368-1(b), Income Tax Regs., that there be a "continuity of interest" on the part of those persons who owned the enterprise prior to the merger.[9] Generally speaking, this means that the owners of an acquired corporation must receive a proprietary interest[10] in the modified enterprise resulting from a transaction which purports to be a "reorganization."[11] For purposes of this case, it means that, in order for us to find a "reorganization" and for section 354(a) to apply, the consideration received by petitioners in exchange for Commerce guaranty stock must be characterized as stock in citizens.[12] See *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. 557, 607 F.2d 970, 973-974 (1979).

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[9]For a review of the development of the continuity-of-interest test, see *West Side Fed. S. & L. Ass'n of Fairview Pk. v. United States*, 494 F.2d 404, 406-408 (6th Cir. 1974). See generally Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 14.11 (4th ed. 1979) (hereinafter Bittker & Eustice), discussing the evolution of the test and its application to not only mergers, but to the other types of transactions defined as "reorganizations" in sec. 368(a)(1).

[10]The interest received is subject to both qualitative and quantitative restrictions. Bittker & Eustice, par. 14.11 at p. 14-20.

[11]The continuity-of-interest doctrine was devised as a means of denying tax-free status to otherwise taxable transactions (such as sales) that happen to meet the literal definition of a reorganization. Bittker & Eustice, pars. 14.03 and 14.11.

[12]Sec. 354(a) permits the receipt of "stock or securities" pursuant to a plan of reorganization; however, the receipt of securities *alone* will not satisfy the continuity-of-interest test. *LeTulle v. Scofield*, 308 U.S. 415 (1940). Petitioners and the other guaranty stockholders of Commerce received only one type of consideration from Citizens (i.e., savings accounts evidenced by passbooks and time certificates), and it must, therefore, be classified as "stock" if petitioners are to prevail.

Not surprisingly, petitioners contend that they exchanged guaranty stock in Commerce for "stock" in Citizens pursuant to a plan of reorganization and that, under section 354(a), no gain was required to be recognized on the exchange. They emphasize that, like shareholders in a corporation that does issue "stock" in the traditional sense, holders of savings accounts in Citizens have voting rights, the right to pro rata distributions of earnings and surplus, and the right to share in Citizens' assets upon liquidation. See Bittker & Eustice, par. 14.31 at 14-94 and 14-95. In support of their position, petitioners also point out that section 7701(a)(7) and (8) defines the terms "stock" and "shareholder" as follows:[13]

> (7) Stock.—The term "stock" includes shares in an association, joint-stock company, or insurance company.
>
> (8) Shareholder.—The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

Respondent's position is that the merger of Commerce into Citizens was not a "reorganization" for tax purposes because petitioners and the other guaranty stockholders of Commerce did not receive a significant proprietary interest in Citizens and that, therefore, section 354(a) has no application here. Respondent acknowledges that, to some extent, the savings accounts received by petitioners represent an equity interest in Citizens, but he emphasizes that they are not the equivalent of ordinary shares of stock. Rather,

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[13]These definitions apply only "where not otherwise distinctly expressed or manifestly incompatible with the intent" of the provision in questiion. Sec. 7701(a). Thus, they are not necessarily determinative of the issue presented here. See *Carlberg v. United States*, 281 F.2d 507, 513-514, fns. 8 and 9 (8th Cir. 1960).

respondent argues, a savings account in Citizens is the equivalent of cash; he views the relationship between a savings account holder and Citizens as basically one of creditor and debtor because, he contends, for all practical purposes a Citizens savings account is withdrawable upon written demand.[14] Respondent would thus characterize a savings account in Citizens as "a hybrid interest, representing debt which is the equivalent of cash while, at the same time, having certain equity features" which are not sufficient to meet the requirements of the continuity-of-interest test in the circumstances of this case.[15]

The question whether savings accounts in a Federally-chartered mutual savings and loan association may be characterized as "stock" for purposes of the provisions of the Internal Revenue Code relating to tax-free reorganizations has not heretofore been considered by this Court. However, the issue has been decided by a number of other courts, and they have uniformly rejected the position here taken by respondent.

In *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971), a State-chartered building and loan association with both "permanent shares" and "savings shares" outstanding had transferred its assets to a Federally-chartered mutual

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[14]Respondent minimizes the effect of the 1-year restriction on withdrawal from the savings accounts received by the guaranty stockholders of Commerce by emphasizing that they had borrowing privileges against those deposits.

[15]See Rev. Rul. 69-6, 1969-1 C.B. 104. Respondent has ruled, however, that the proprietary interest represented by savings accounts such as the ones in question is sufficient for purposes of the continuity-of-interest test in cases involving the merger of two mutual savings and loan associations. See Rev. Rul. 69-3, 1969-1 C.B. 103; Rev. Rul. 78-286, 1978-2 C.B. 145 (continuity-of-interest test satisfied even in the absence of voting rights). Cf. Rev. Rul. 69-646, 1969-2 C.B. 54 (merger of building and loan association having only savings accounts into one having savings accounts and guaranty shares held to satisfy the continuity-of-interest requirement).

savings and loan. Holders of savings shares in the State association received like shares in the Federal association. In additon, $65,000 was paid to the State association and distributed to its permanent shareholders in a complete liquidation. The taxpayers treated the transaction as a reorganization within the meaning of section 368(a)(1)(C) and (2)(B), and the correctness of their so doing turned on the question whether savings shares in the Federal association constituted "voting stock" within the meaning of that section. The court held that they did, noting that although "such shares have some of the indicia of a creditor-debtor relationship, nevertheless at the same time such shares also possess many of the attributes of a proprietary type interest.[16] *Everett v. United States, supra* at 360. The court went on to hold that the transaction met the continuity-of-interest test[17] even though the permanent shareholders of the State association had been "cashed out."

A similar conclusion was reached in *West Side Fed. S. & L. Ass'n of Fairview Pk. v. United States*, 494 F.2d 404 (6th Cir. 1974) (hereinafter *West Side*), which in all material respects is identical to the case before us. There, the issue was whether the statutory merger of a State-chartered savings and loan into a Federally-chartered mutual savings and loan was a "reorganization" within the meaning of section 368(a)(1)(A). Each savings account in the State association had been exchanged for a savings account of

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[16]The proprietary rights focused on by the court—i.e., the right to vote and participate in management, the right to bonus payments contingent on earnings, and the right to share in liquidation proceeds—were basically the same as those possessed by holders of savings accounts in Citizens.

[17]It should be noted that the requirement of sec. 368(a)(1)(C) that an exchange be "solely" for "voting stock" is stricter than the judicially-created continuity-of-interest doctrine. See *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 198 (1942).

equal value in the Federal association, and each share of capital stock in the State association had been converted into a savings account in the Federal association with a withdrawal value of $2,500. The Government argued that this transaction failed to meet the requirement of a continuity of proprietary interest, stressing the fact that prior to the merger the State association had two distinct classes of contributors to its capital. It also emphasized the fact that (1) savings accounts in the Federal association were withdrawable at any time with little or no restriction, (2) such savings accounts were Federally insured, and (3) voting rights attaching to such savings accounts were more restricted than the rights enjoyed by the former shareholders of the State association.

The court in *West Side* emphasized that cases dealing with the continuity-of-interest requirement have focused upon the nature of the interest received and that it need not be identical to the interest given in an exchange.[18] This being so, and because a savings account is the only proprietary interest available in a Federal mutual savings and loan association, the court stated that "it is improper to ignore the proprietary rights * * * [of holders of these savings accounts] and concentrate only on their rights as creditors." 494 F.2d at 411. The court held that the exchange of savings accounts and stock in the State association for savings accounts in the Federal association satisfied the continuity-of-interest test. Specifically, it found that each owner of a proprietary interest in the State association had acquired a proprietary interest in the Federal association which was definite and material and which represented a substantial

[18]The court concluded its opinion with a quote from *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 386 (1935), as follows: "True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the statute."

part of the value of the stock that was given up.

The same result was reached by the Court of Claims in *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. 557, 607 F.2d 970 (1979) (hereinafter *Capital*), also involving the question whether the merger of a savings and loan association having guaranty stock into a mutual savings and loan association[19] qualified as a reorganization under section 368(a)(1)(A). Pursuant to an agreement of merger, all savings accounts and guaranty stock of the acquired association were converted into voting withdrawable savings accounts in the mutual association. The Government argued that the holders of guaranty stock had "cashed in" or sold their equity interest by accepting withdrawable savings accounts in exchange for the stock and that, therefore, the merger failed to meet the continuity-of-interest test.

The Court of Claims observed that there were several problems with the Government's argument that savings accounts in mutual savings and loan associations should be treated simply as debt interests, "beginning with the fact that these accounts are hybrid interests having the seemingly inapposite characteristics of both equity interests and debt interests." *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. at ___, 607 F.2d at 974. As in *West Side, supra*, the court noted that in cases involving the continuity-of-interest doctrine the focus must be on the nature of the interest received in an exchange and that savings accounts are the only interests with proprietary and equity rights available in a mutual savings and loan. In holding that the merger in question did qualify as a reorganization under section 368(a)(1)(A), the Court of Claims stated (*Capital S. & L.*

[19]Apparently, both of the savings and loan associations that were parties to the merger in *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. 557, 607 F.2d 907 (1979), were incorporated under the laws of the State of Washington, as was Commerce.

Ass'n v. United States, 221 Ct. Cl. at ___, 607 F.2d at 976):

> As the law assumes that someone must own an association or corporation, we join the courts in *West Side, supra*, and *Everett, supra*, in refusing to reach a decision which illogically implies that * * * [a mutual savings and loan association is] without owners and which may unduly hinder otherwise desirable reorganizations. Though savings accounts are easily converted into cash, as long as the account remains unliquidated, its holders continue their equity investment in the association in the form of share accounts. * * * [Fn. reference omitted.]

Thus, in these and other cases,[20] the courts have uniformly rejected respondent's argument that the receipt of savings accounts in a mutual savings and loan association in exchange for stock will not satisfy the continuity-of-interest test. The courts have recognized the hybrid nature of accounts in mutual savings and loan associations but have concluded that such proprietary rights as the right to vote, the right to receive pro rata distributions of earnings, and the right to share in distributions of assets upon liquidation are sufficient to cause such accounts to meet the continuity-of-interest requirement. Respondent cites only one case involving this question in support of his position, *Home Savings and Loan Ass'n v. United States*, 514 F.2d 1199 (9th

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[20]In addition to *Everett, West Side*, and *Capital*, cases holding that a savings account in a mutual savings and loan constitutes "stock" for purposes of finding a reorganization include *Rocky Mtn. Fed. Sav. & L. Ass'n v. United States*, 473 F.Supp. 779 (D. Wyo. 1979) (merger of State stock savings and loan into Federal nonstock savings and loan), and *First Federal Sav. and Loan Ass'n v. United States*, 452 F.Supp. 32 (N.D. Ohio 1978) (same).

It has also been recognized outside the area of reorganizations that savings accounts in mutual savings and loan associations represent equity interests. See the discussion and cases cited in *Capital*, 221 Ct. Cl. at ___, 607 F.2d at 975.

Cir. 1975), and that case—involving guaranty stock associations on both sides of the merger transaction—is readily distinguishable from cases like the instant one where stock in a savings and loan association was exchanged for savings accounts in a mutual savings and loan.[21]

We recognize that respondent is not without arguments and that treating savings accounts as "stock" for purposes of the "tax-free" reorganization provisions of the Internal Revenue Code raises a number of logical and practical ad-

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[21]In *Home Savings and Loan Ass'n v. United States*, 514 F.2d 1199 (9th Cir. 1975), the taxpayer, a State savings and loan association having guaranty stock in addition to "withdrawable shares," acquired two other State guaranty stock savings and loan associations in a transaction that it characterized as a reorganization. Home first purchased for cash all of the outstanding guaranty stock of the two acquired associations. Subsequently, the acquired associations were merged into Home. Upon the merger, the guaranty stock of the acquired associations was cancelled, and the holders of "withdrawable shares" and "investment certificates" in the acquired associations exchanged them for "withdrawable shares" in Home. Based primarily upon California law and the terms of the instruments before it, the court held that the withdrawable shares and investment certificates of the acquired associations could not be considered as "stock" for purposes of sec. 368(a)(1)(A). Rather, they were found to be debt instruments and, because the former owners of the acquired associations (i.e., the guaranty stockholders) had been "cashed out," the transaction was held to lack the continuity of interest requisite to a valid "reorganization."

In the present case, the question whether the holders of savings accounts in the acquired association (Commerce), as well as its guaranty stockholders, may be considered as its former owners is not in issue. Here, the question whether there is sufficient continuity of interest depends upon the nature of the savings accounts that the guaranty stockholders received from Citizens, a mutual savings and loan association having only savings accounts and no stock per se. The Ninth Circuit in *Home Savings and Loan Ass'n v. United States, supra*, at 1208-1209, made it clear that the nature of such savings accounts was not there in issue, stating in this connection that:

> Assuming that there must exist in all associations a proprietary interest, such broad and uniform interest may well serve that purpose. Its capacity to do so should not be impaired by the fact that it also may constitute debt. However this may be, we are not confronted here with such a case. [Fn. reference omitted.]

ministrative problems.[22] If this were a question of first impression, we would feel free to give greater weight to those problems in reaching our decision. Given the long outstanding and unbroken line of holdings of the several cited judicial authorities, however, that savings accounts in a mutual savings and loan association qualify as "stock," we feel constrained to follow the guidance of those decisions, the first of which is now over 10 years old. A corporate reorganization, in which the stakes are usually very high, requires careful advance planning and, consequently, the need for certainty in the law is great. The practicality of many reorganizations is materially affected, if not determined, by the tax consequences, and the participants need to know the ground rules. The current plight of the savings

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[22]For example, the general purpose of the reorganization provisions is to postpone the recognition of gain realized upon the shifting of business interests into a modified corporate form. Thus, under sec. 358(a)(1), the basis of property received in a reorganization exchange (here, the savings accounts) is the same as the basis of the property surrendered (the guaranty stock). The amount of petitioners' bases for their several blocks of stock, as shown above, is much less than the amounts in the savings accounts they received and yet, practically speaking, savings accounts are viewed as the equivalent of cash.

Petitioners suggest that the gain realized from the exchange of guaranty stock for savings accounts should be recognized only upon withdrawals from the passbook accounts and upon the maturity of the time certificates. (It is unclear as to whether petitioners suggest that the time certificates should be taxed upon maturity even though the funds are not withdrawn.) The withdrawal from a savings account does not constitute a "sale or exchange" as those terms are generally understood, but such withdrawals could be viewed as the proceeds of redemptions to be tested under the provisions of sec. 302(b). If both deposits and withdrawals were made with respect to savings accounts received in an exchange for stock, i.e., unless the accounts received in the reorganization are kept carefully separate, serious problems of determining the shifting bases of the accounts and the character of the withdrawals would arise.

In the final analysis, however, given the hybrid nature of the savings accounts in question, logical and practical problems would arise regardless of whether the accounts are treated as a debt interest or as an equity interest.

and loan industry[23] brings to mind Justice Powell's statement in *United States v. Byrum*, 408 U.S. 125, 135 (1972):[24]

> When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

We hold for petitioners.[25]

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[23]See, e.g., H. Rept. No. 97-201, to accompany H.R. 4242 (Pub. L. 97-34), 145-146 (1981); Wall Street Journal, Feb. 18, 1982, at 4, cols. 1 and 2; Washington Post, Feb. 22, 1982, at A1, col. 3 and A12, col. 1.

[24]Paraphrasing the words of the Supreme Court in *United States v. Byrum*, 408 U.S. 125, 134, fn. 8 (1972), we are not so much concerned with whether petitioners relied on the precedents discussed herein, but with the probability that others have relied on them in good faith in planning and carrying out mergers of savings and loans. At least with respect to the question of the character of savings accounts in a Federally-chartered mutual savings and loan, a uniform rule should be applied nationwide. See and compare *Allstate Sav. & Loan Ass'n v. Commissioner*, 600 F.2d 760, 762 (9th Cir. 1979), affg. 68 T.C. 310 (1977).

[25]Respondent has made an alternative argument that, if the receipt of savings accounts in Citizens is sufficient for purposes of the continuity-of-interest test, the accounts nonetheless constitute "other property" ("boot") for purposes of sec. 356(a)(1) and, therefore, result in recognized gain to petitioners. Respondent submits that this argument is consistent with the decisions of the courts in *Everett*, *West Side*, and *Capital*, *supra*.

Although respondent's alternative argument may in the abstract be consistent with the holdings of those cases, we think the argument fails to comport with the facts of either those cases or the present case. Sec. 356(a)(1) applies where property qualifying for "tax-free" exchange under sec. 354 and, *in addition*, some other property or money is received. Here, petitioners received only one type of property, savings accounts (in the form of passbooks and time certificates), and the cash deposit and proprietary rights represented by those accounts are not separable. See *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. at ___, 607 F.2d at 977. Respondent seems to have recognized as much in Rev. Rul. 69-6, 1969-1 C.B. 104, where it is stated that the obligation

(footnote continued on following page)

To reflect the foregoing,

Decision will be entered for the petitioners.

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of a Federal nonstock mutual association to deliver cash deposits "is not severable from its obligation to deliver * * * a proprietary interest. Both the cash equivalents and the proprietary interests are evidenced" by savings accounts. Given this inseparability of rights, we think this case must turn solely on the question whether the savings accounts are "stock." We find no merit in respondent's alternative argument.

Decision of the United States Tax Court.

United States Tax Court, Washington, D.C. 20217.

Harold T. and Marie B. Paulsen, Petitioners, v. Commissioner of Internal Revenue, Respondent. Docket No. 17549-79.

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion, filed March 2, 1982, it is

ORDERED AND DECIDED that there is no deficiency in petitioners' Federal income tax for the taxable year 1976.

/s/ C. Moxley Featherston
C. Moxley Featherston
Judge

Entered: MAR 8 1982

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

Harold T. and Marie T. [sic] Paulsen, Appellees vs. Commissioner of Internal Revenue, Appellant. No. 82-7329. Tax. Ct. No. 17549-79.

Filed: August 16, 1983.

Appeal from the United States Tax Court.

Argued and Submitted April 5, 1983. Decided ....., 1983.

BEFORE: HUG, POOLE, AND NORRIS, Circuit Judges.

NORRIS, Circuit Judge:

Pursuant to a merger plan between a stock savings and loan association and a mutual savings and loan association, shareholders in the stock association exchanged their "guaranty shares" for passbook accounts and time certificates of deposit in the mutual association. The Tax Court, believing that it was "constrained to follow the guidelines of several circuit court decisions holding [transactions such as this one to be tax free]," held the exchange to be a stock for stock transaction not taxable under 26 U.S.C. § 354. *Paulsen v. Commissioner*, 78 TC 291, 302-303, 303 n.24 (1982).

On appeal, the Government argues that the predominant characteristics of the passbook accounts and time certificates received in the exchange are those of debt rather than those of equity, and that, in reality, the shareholders simply sold their guaranty shares for the equivalent of cash. We agree and therefore reverse.

I

The material facts are not in dispute.

Commerce Savings and Loan Association (Commerce) was a stock savings and loan association chartered by the State of Washington and authorized to issue guaranty stock,

to offer various clases of savings accounts, and to make loans. Each holder of a savings account or of guaranty stock and each borrower was a "member" of Commerce. With regard to matters requiring the approval of Commerce's members, holders of guaranty stock were entitled to one vote per share, holders of savings accounts to one vote per $100 on deposit, and borrowers to one vote each.

A certain amount of guaranty stock was "nonwithdrawable" and constituted the fixed capital of Commerce. Under state law, only holders of guaranty stock had a proprietary interest in the assets and net earnings of Commerce. Guaranty stockholders were entitled to elect a majority of Commerce's board of directors.

Harold T. Paulsen was president and a director of Commerce. On June 30, 1976, he and his wife owned 17,459 shares of Commerce guaranty stock with a cash basis of $56,802.

Citizens Federal Savings and Loan Association (Citizens) is a federally chartered mutual savings and loan association. As a mutual savings and loan association, it has no capital stock. Instead, it is "owned" by its depositors. With regard to matters on which management must obtain approval, each holder of a savings account is entitled to one vote per $100 on deposit (or fraction thereof), up to a maximum of 400 votes. Each borrower from Citizens is also entitled to one vote.

Citizens' articles and bylaws provide that twice each year Citizens' net earnings and any surplus are to be distributed to savings account holders on a pro rata basis. In the event of the liquidation or dissolution of Citizens, savings account holders are entitled to a pro rata distribution of its assets. Citizens must also honor requests by its savings account holders to withdraw funds within thirty days. Citizens may

"redeem" any of its savings accounts at any time by paying to the holder the "withdrawal amount", i.e., the amount on deposit.

On July 1, 1976, Commerce was merged into Citizens. Under the merger plan, shareholders of Commerce were to exchange their guaranty shares for passbook accounts and time certificates of deposit in Citizens. Each guaranty share of Commerce was to be exchanged for a $12 deposit in a Citizens passbook account, subject to the restriction that such deposits could not be withdrawn for one year. Alternatively, Commerce shareholders could exchange their guaranty stock for time certificates of deposit in Citizens with maturities ranging from one to ten years, again at the rate of $12 per share. Although under either option former Commerce shareholders would not receive cash immediately, the merger plan authorized them to borrow against such accounts at an interest rate of 1.5 percent above the passbook rate. Normally, Citizens savings account holders could borrow at a rate of 2 percent higher than the passbook rate.

On July 1, 1976, the Paulsens exchanged their 17,459 shares of Commerce guaranty stock for passbook accounts and certificates of deposit as follows:

Number of Shares	Date of Acquisition	Cost Basis	Consideration Received		Gain Realized
			Amount	Type	
3,356	3/ 8/63	$7,500	$40,272	Passbook	$ 32,772
3,359	6/26/70	7,500	40,308	2 yr. cert.	32,808
3,358	12/31/71	7,500	40,269	18 mos. cert.	32,796
3,358	10/24/72	7,500	40,296	18 mos. cert.	32,796
667	1/ 1/73	7,530	8,004	1 yr. cert.	474
1,971	2/19/74	6,000	23,652	3 yr. cert.	17,652
861	6/30/76	7,500	10,332	3 yr. cert.	2,832
529	6/30/76	5,772	6,348	4 yr. cert.	576
17,459		$56,802	$209,508		$152,706

The Paulsens determined that the merger was a reorganization as described in § 368(a)(1) and that their gain from the transaction was tax free under § 354(a). They therefore did not report the gain on their 1976 income tax return.

The Commissioner issued a statutory notice of deficiency, asserting that the Paulsens were liable for tax on the entire amount. The Paulsens petitioned the Tax Court for redetermination of deficiency. The Tax Court held that the passbook accounts and the time certificates of deposit were to be classified as stock for purposes of § 354 and that the exchange was therefore not taxable. 78 T.C. at 303. The Commissioner filed a timely appeal.

II

In general, all gain from the sale or exchange of property is taxable unless exempted by a specific provision of the Code. 26 U.S.C. § 1001. Section 354 is such a provision. It states in part that:

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

26 U.S.C. § 354(a)(1).

Describing the purpose of § 354, one commentator has written:

> The theory behind [§ 354] is that where a stockholder enters into a reorganization exchange (e.g. a merger), he receives stock of a different corporation from that in which he held stock before, thereby realizing gain. However, since his investment is still tied up in the corporate form, economically he is not very much better off than he was before — for example, he still has no money with which to pay the tax — and consequently, as a matter of congressional policy, gains are

> not recognized at this point. Instead, through the carryover basis provisions, taxation of gain on this exchange is postponed until he disposes of the stock received in the merger in some form of taxable exchange.

Stanley & Kilcullen, *Federal Income Tax Law* 7-8 (1983).

Section 354 applies only when "stock or securities" are exchanged for like property pursuant to a plan of "reorganization". To ensure that the purpose of § 354 is met, courts have added to the definition of reorganization a "continuity of interest" requirement which in the case of statutory mergers is satisfied only if the equity interest of the shareholders in the acquiring enterprise is continued in the new enterprise. *See Home Savings and Loan Ass'n v. United States*, 514 F.2d 1199, 1201 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975); B. Bittker and J. Eustace, *Federal Income Taxation of Corporations and Shareholders*, para. 14.11 (4th ed. 1979).

The interest received need not be the same form of equity interest as that given up. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 386 (1935). Furthermore, the transferor may receive some cash or other property, as long as he or she receives in addition an equity interest in the acquiring corporation that represents a substantial part of the value of the interest given up. *Nelson Co. v. Helvering*, 296 U.S. 374, 377 (1935). The "continuity of interest" requirement is not satisfied, however, if the transferor of shares in the acquired corporation receives only debt and becomes merely a creditor of the new enterprise. *See* B. Bittker and J. Eustace, *supra*; *see also Le Tulle v. Scofeld*, 308 U.S. 415 (1940).

In the discussion that follows, we consider first whether the accounts received by the Paulsens should be characterized as equity, in which case nonrecognition of gain would be appropriate or as debt, in which case recognition is required. We conclude that debt characteristics overwhelmingly predominate.

III

The Paulsens argue that they exchanged their guaranty shares in Commerce for interests in Citizens that too had significant proprietary characteristics. First, they contend, their interests should be considered equity for purposes of section 354 because as holders of Citizens accounts they are entitled to all the rights generally held by shareholders, including the right to vote, the right to share in the profits of the association, and the right to share in any proceeds that may be available should Citizens liquidate. Second, they point out that under the Code, stock is defined to include "shares in an association," 26 U.S.C. § 7701(a)(7), and shareholder is defined to include "member of an association," 26 U.S.C. § 7701(a)(8). Third, the Paulsens argue that Citizens biannual distributions of earnings are "dividends." They note that under Citizens' charter, management is authorized to determine periodically whether any payments are to be made, and their amounts; that the payments are expressly dependent on the financial success of the Association; and that Citizens is not contractually obligated to its depositors to make any payments. This, too, they argue is typical of equity. Finally, the Paulsens note that the interests they received, passbook accounts and certificates of deposit, are the only form of proprietary interest available in Citizens. Thus, regardless of any debt characteristics the instruments they received must have, they argue, they received all of the equity there was to receive. In short, the Paulsens suggest that to hold that their interests are not equity would be to hold that no equity exists in Citizens at all.

The arguments advanced by the Paulsens are virtually identical to those make [sic] by the plaintiff in *Home Savings and Loan Association v. United States*, 514 F.2d 1199 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975). In that case,

plaintiff *Home Savings*, a stock savings and loan association, had acquired the stock of Pasadena Savings and Loan Association (Pasadena) and Savings and Loan Association of Anaheim (Anaheim). Each of the two acquired associations had two forms of capital. Both had guarantee stock, the proceeds of which were required by California law to be set aside and maintained "as a fixed and permanent capital of the association." *Id.* at 1202. In addition, Pasadena had withdrawable shares, which enjoyed no statutory entitlement to interest, were liable for debts or assessments of the corporation and were subordinated to the interests of creditors in the event of a liquidation. Anaheim, on the other hand, had investment certificates which, in contrast to withdrawable shares, had a statutory right to interest, were not liable for corporate debts or assessments, and had priority in a liquidation. *Id.* at 1202-03. The acquisition by Home was effected by Home purchasing the guarantee shares of the two associations and exchanging its withdrawable shares for the withdrawable shares of Pasadena and the investment certificates of Anaheim. The question before the court was whether that transaction more nearly resembled a stock purchase than a tax-free reorganization. The answer to that question depended on whether the withdrawable shares and investment certificates were classified as debt or as equity.

To make that determination, the *Home Savings* panel carefully examined the characteristics of the interests Home acquired from Pasadena and Anaheim, and concluded that

> [n]either withdrawable shares nor investment certificates under the circumstances of this case partake sufficiently of equity characteristics to permit their classification as such.

Id. at 1206. We conduct the same examination of the interests acquired in the Citizens merger, comparing them to

those found to be debt in *Home Savings*. Our examination compels the conclusion that, like the interests acquired in *Home Savings*, the interests we must classify in this case do not "partake sufficiently of equity characteristics," *id.* to so classify them.

First, there are indeed some voting rights attached to the Citizens passbook accounts. Yet as we noted in *Home Savings*, under California law holders of debt can be afforded voting rights. 514 F.2d at 1206; Ca. Corp. Code § 306. Thus the fact that voting rights are attached to a particular interest does not make it equity. Moreover, the voting rights received by Citizens depositors are quite dissimilar to those of holders of equity interest in other corporations. Every holder of a Citizens savings account is entitled to one vote per $100 on deposit (up to a maximum of 400 votes). Yet the Paulsens' proportional ownership and their voting power are, unlike that of shareholders in other entities, infinitely dilutable. The addition of any depositor dilutes the voting power of all. Finally, the Paulsens have not refuted the Commissioner's contention that in practice depositors generally sign proxies giving management their vote upon opening accounts. *See York v. Federal Home Loan Bank Board*, 624 F.2d 495, 497 n. 1 (4th Cir.), *cert. denied*, 449 U.S. 1043 (1980). Thus whatever formal right to vote the depositors may possess, they sign away upon depositing their first dollar.

Second, though Citizens does indeed distribute what it calls "dividends," taxpayers do not dispute the Commissioner's assertion that in fact Citizens pays a fixed, preannounced rate on all accounts. In practice, the distributions are identical in all essential respects to the interest paid by stock savings and loan associations. Indeed, as a matter of economic common sense they would have to be. It is fanciful to suggest that depositors deciding where to put their money

attach any weight to whether an institution is a mutual or a stock association. Indisputably, they are motivated by the amount of interest they can receive and the security of their deposits. Thus, again as we noted in *Home Savings*, competition will "assure withdrawable shareholders a reasonably steady rate of return," and will assure that interest paid by mutual associations is competitive with interest paid by stock associations and commercial banks. 514 F.2d at 1206. Our court in *Home Savings* was also persuaded to classify the withdrawable shares and investment certificates as debt by the fact that the Internal Revenue Code treated the instruments exactly as it does interest. They were deductible to the payor, 26 U.S.C. § 591, and did not qualify for the dividend exclusion of § 116. Because the same is true of the so-called dividends paid by Citizens, we are equally persuaded that those payments do not qualify the passbook accounts as equity.

Third, the Paulsens' right to share in the proceeds in the speculative and unlikely event of a solvent liquidation cannot be considered a significant part of the value of the interest they received in exchange for their guaranty stock and thus cannot be considered as a significant factor in determining whether what they received was debt or equity. The *Home Savings* panel attached no weight to similar rights acquired by the plaintiff in that case, and the Supreme Court aptly described the significance of liquidation rights such as the Paulsens in *Society for Savings v. Bowers*, 349 U.S. 143, 150 (1955) when it noted that

> it stretches the imagination very far to attribute any real value to such a remote contingency [as a solvent liquidation], and when coupled with the fact that it represents nothing which the depositor can readily transfer, any theoretical value reduces almost to the vanishing point.

Finally, the *Home Savings* panel found very persuasive the fact that the interests that *Home* received, besides being dissimilar to normal equity interests, had many of the normal characteristics of debt. The withdrawable shares and investment certificates were not subordinated to the interests of creditors and were not permanent contributions to capital. 514 F.2d at 1207. These facts hold equal sway in the case of the Citizens merger. The Paulsens' interest in Citizens is not subordinated to the interests of Citizens' creditors or to anyone else. Their deposits are not permanent contributions to the capital of Citizens but instead, may be withdrawn (after one year) at will. Moreover, unlike the situation in *Home Savings*, under the Citizens merger agreement the Paulsens may borrow against their accounts at a rate even more favorable than that Citizens charges its other account holders. These factors persuade us, as they did our court in *Home Savings*, that the Citizens accounts are essentially the equivalent of cash.

Thus, were the interests acquired by the Paulsens identical to the withdrawable shares and investment certificates acquired by Home Savings, we would have no trouble whatsoever concluding that they should be classified as debt. The Paulsens point out, however, that their interests, unlike those at issue in *Home Savings*, are the only form of capital in the association. In *Home Savings*, Pasadena and Anaheim both had guarantee stock in their capital structure in addition to the withdrawable shares. Citizens, however, has no such stock. Its only owners are the depositors. This difference, the Paulsens claim, is critical. They make two arguments. First, they point out, the *Home Savings* panel stated that it "might be willing to weigh more heavily . . . (the) equity-like features (of the withdrawable shares and investment certificates) were there no greater equity-like interests involved." 514 F.2d at 1206. Second, they argue that to hold

the passbook accounts are debt would be to hold that no capital exists in Citizens at all, which, they claim, is of course not correct.

We find both arguments without merit. Though the *Home Savings* panel did indicate that it might be persuaded to classify the withdrawable shares and investment certificates as equity were they the only interests in existence, they were not. Thus the language cited by the Paulsens is dictum, and we have no reason to believe that the *Home Savings* panel ever seriously considered the question of what weight to give the fact that a particular interest is the only ownership interest in an association. Second, the Paulsens' argument simply misses the point. The argument that the passbook accounts are the only equity in Citizens and thus must be classified as equity for purposes of § 354 confuses the viewpoint of the corporation with that of the individual taxpayer. From the Association's point of view, there can be little doubt that the passbook accounts are equity in the sense that they represent the entire capital structure of the Association. This strikes us as irrelevant, however, as far as § 354 is concerned. The focus of that section is on the character of interests received from the point of view of the taxpayer, not that of the corporation. The critical question for purposes of § 354 is whether the position of the shareholder in the reorganized entity has really changed: has his risk increased or decreased? is his investment more or less liquid? If the position of the shareholder has changed to that of a creditor with ready access to his money then, regardless of the nature of his interests from the corporation's point of view, those interests cannot qualify as stock for purposes of § 354.

This is exactly what has happened in this case. Here, the Paulsens have exchanged their guaranty shares for passbook accounts and time certificates of deposit that, despite certain formal equity characteristics, are in reality indistinguishable

from ordinary savings accounts and are essentially the equivalent of cash. They have converted a risky investment into a risk-free one and a highly illiquid position into a highly liquid one. We see no reason why, under these circumstances, the gain they experienced by doing so should not be recognized.

This analysis finds support in *York v. Federal Home Loan Bank Board*, 624 F.2d 495 (4th Cir. 1980). There, the court was faced with the argument that the conversion of a mutual association into a stock savings and loan association had deprived depositors in the mutual of valuable property rights in the association in the form of rights to vote and to share in the proceed of any liquidation. Those rights were similar to those possessed by holders of Citizens passbook accounts and, in *York* too, the depositors argued that their interests had to be considered equity because they were the legal owners of the association. The Fourth Circuit, however, held that the interests of depositors had so little value as equity that they did not rise to the status of property rights. The court noted that

> [a]lthough the depositors are the legal "owners" of a mutual savings and loan, their interest is essentially that of creditors of the association and only secondarily as equity owners."

Id. at 499-500.

Thus, the Fourth Circuit held, the conversion of the mutual to a stock association would not deprive depositors of property rights because their "only actual rights, their rights as creditors of the association, will remain unchanged by the conversion." *Id.* at 500.

IV

We recognize that our decision conflicts with that reached by several other courts. In *Capital Savings and Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979),

the court held that a merger similar to that here, in which guaranty shareholders exchanged their shares for savings accounts in the acquiring mutual savings and loan association, was a tax-free reorganization. The court emphasised that savings accounts were the only form of equity in mutual associations. It stated that to conclude that such accounts constituted debt would be tantamount to saying that mutual savings and loan associations have no owners. Similar results were reached in *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974), and in *Everett v. United States* 448 F.2d 357 (10th Cir. 1971).

We are neither bound nor persuaded by those authorities. As noted above, we do not hold that a mutual savings and loan association is without owners. We merely hold that the interests at issue here, though they may be ownership interests for some purposes, do not "partake sufficiently of equity characteristics" to qualify this transaction as a tax free reorganization.[1]

REVERSED.

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[1]Though we do not assign the argument much weight, we agree with the Commissioner that serious administrative difficulties would result were we to affirm the Tax Court. The Paulsens would have in their passbook account and in each of seven separate time certificates a cash basis less than the actual dollar amount on deposit. Determining and taxing the gain each time a withdrawal is made would produce substantial accounting and administrative problems.

Judgment of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

Harold T. and Marie B. Paulsen, Appellees, vs. Commissioner of Internal Revenue, Appellant, TAX# 17549-79. No. 82-7329.

JUDGMENT
WESTERN WASHINGTON

Upon Petition to Review a Decision of The Tax Court of the United States,

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, on April 5, 1983 and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is REVERSED.

Filed and entered August 16, 1983.

Text of Statutes and Regulations Involved.

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 354. Exchanges of Stock and Securities in certain Reorganizations.

(a) *GENERAL RULE* —

(1) *IN GENERAL* — No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * *

SEC. 368. Definitions Relating to Corporate Reorganizations.

(a) *REORGANIZATION* —

(1) *IN GENERAL* — For purposes of parts I and II and this part, the term "reorganization" means —

(A) a statutory merger or consolidation;

* * * *

SEC. 7701. Definitions.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof —

* * * *

(3) *CORPORATION* — The term "corporation" includes associations, joint-stock companies, and insurance companies.

* * * *

(7) *STOCK* — The term "stock" includes shares in an association, joint-stock company, or insurance company.

(8) *SHAREHOLDER* — The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

Code of Federal Regulations, Title 12, Part 544 (as in effect on July 1, 1976)

§ 544.1 Issuance of charter.

* * * *

(b) *Charter K. (rev.).* If expressly requested in the Petition for Charter, or in the Application for Conversion into a Federal association, the Board, in lieu of Charter N, will issue a Charter K (rev.), reading as follows:

* * * *

3. *Objects and powers.* The objects of the association are to promote thrift by providing a convenient and safe method for people to save and invest money and to provide for the sound and economical financing of homes; and, in the accomplishment of such objects, it shall have perpetual succession and power: . . . . (6) To raise its capital, which shall be unlimited, by accepting payments on savings accounts representing share interests in the association; . . . .

* * * *